STAFF PAPER

March 2014

IFRS Interpretations Committee Meeting

IFRS IC meetings: May-Nov 2010, Nov 2012, May 2013, Jan 2014
IASB meetings: Sep 2011, Dec 2012

Project	**IAS 12 *Income Taxes*—Recognition of deferred tax assets for unrealised losses**		
Paper topic	Cover note—Requirements for the amendment to IAS 12 and analysis of unintended consequences		
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Introduction

1. At its meeting in January 2014, the IFRS Interpretations Committee (the Interpretations Committee) asked the staff to draft an amendment to IAS 12 *Income Taxes* that would clarify the accounting for deferred tax assets for unrealised losses on debt instruments measured at fair value.

2. Subject to reviewing the draft amendment to IAS 12, the Interpretations Committee supported the staff recommendation that such an amendment to IAS 12 should mainly be an illustrative example, with other amendments to IAS 12 only made if the clarification through an illustrative example is insufficient.

3. The Interpretations Committee also asked the staff to assess, when drafting the amendment to IAS 12, whether the proposed amendments might cause any unintended consequences for the accounting for deferred tax arising in relation to non-financial assets measured at fair value.

Objective of Staff Papers 2 and 2A

4. The Objective of Staff Papers 2 and 2A is to:

(a) present the draft amendment to IAS 12 for discussion by the Interpretations Committee; and

(b) analyse whether the proposed clarifications might result in unintended consequences for non-financial assets measured at fair value.

Structure of the Staff Papers 2 and 2A

5. This cover note therefore:

   (a) summarises the requirements that the draft amendment to IAS 12 has to meet according to the previous discussions on this issue;

   (b) analyses whether the draft amendment might result in unintended consequences for non-financial assets measured at fair value;

   (c) makes a staff recommendation; and

   (d) asks questions to the Interpretations Committee.

6. Staff Paper 2A includes the draft amendment to IAS 12.

7. At its meeting in January 2014, the Interpretations Committee noted that the amendment should explain the following aspects in the application of the principles of IAS 12:

   (a) An unrealised loss on a debt instrument measured at fair value gives rise to a deductible temporary difference if the holder of the debt instrument expects to recover its carrying amount by holding it to maturity and collecting all of the contractual cash flows, and if the loss is not tax-deductible until realised.

   (b) An entity assesses the utilisation of deductible temporary differences related to unrealised losses on debt instruments measured at fair value in combination with other deferred tax assets. If tax law, however, restricts the utilisation of deductible temporary differences, so that an entity can only utilise certain tax deductions against taxable profits of a specific type (for example, if it can deduct capital losses only against capital gains), the entity must still assess such a deductible temporary difference in combination with other deductible temporary differences, but only with deductible temporary differences of the appropriate type.

(c) When estimating probable future taxable profit for the purposes of recognising deferred tax assets, an entity assumes that it will recover an asset for more than its carrying amount, provided such a recovery is probable.

(d) Probable future taxable profit against which existing deductible temporary differences are assessed for utilisation excludes tax deductions represented by those deductible temporary differences.

(e) It should explain the approach to apply in the assessment of the utilisation of deductible temporary differences when it is probable that the entity will utilise only part of its deductible temporary differences. This was raised in the context of a situation in which all three sources of taxable profits (ie future reversal of existing taxable temporary differences, future taxable profits, and tax planning opportunities) are available but together are insufficient for the recognition of all deferred tax assets.

(f) It should explain how an entity should determine the amount of deferred tax to recognise in other comprehensive income, compared with the amount to recognise in profit or loss, when the entity cannot recognise all deferred tax assets because of having insufficient future taxable profits. The Interpretations Committee noted that this determination should be on a reasonable pro-rata allocation, unless tax law requires a different allocation.

8. The Interpretations Committee also tentatively decided to develop the amendment to IAS 12 for application to debt instruments measured at fair value in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*, as well as those measured at fair value in accordance with IFRS 9 *Financial Instruments*.

9. In addition, we proposed in paragraph 7 of Staff Paper 2A for the January 2014 IASB meeting that the illustrative example should be drafted taking into consideration the following assumptions:

(a) The issue raised with the Interpretations Committee is relevant in particular for banks and insurers.

(b) Banks and insurers hold portfolios of debt instruments measured at fair value.

(c) A large part of the unrealised gains and losses on these debt instruments and the related deferred taxes is recognised in other comprehensive income (OCI).

(d) The tax base of these debt instruments is usually some sort of cost basis.

(e) Unrealised gains and losses on these debt instruments are neither taxable nor tax-deductible until realised.

(f) Holding portfolios of debt instruments measured at fair value usually implies that both taxable temporary differences and deductible temporary differences arise within a portfolio at the same time (on different debt instruments).

(g) Tax law sometimes distinguishes between capital gains and losses and ordinary income and losses. While capital losses can only be offset against capital gains, ordinary losses can in some jurisdictions be offset against both capital gains and ordinary income.

(h) It is not probable that the bank or insurer can utilise all the deductible temporary differences, because all three sources of taxable profits together are insufficient for the recognition of all deferred tax assets.

(i) In the case that taxable profits are insufficient for the recognition of all deferred tax assets, it is not clear which ones are recognised. This is important because some of them are recognised in profit or loss whereas others are recognised in OCI.

10. In Staff Paper 2A for the January 2014 IASB meeting, we proposed the following amendments to IAS 12 next to the illustrative example, because we considered that the illustrative example by itself would not provide enough clarification on these issues:

(a) Paragraph 20 of IAS 12 should be amended to clarify that a temporary difference related to assets measured at fair value might reverse before the carrying amount of an asset is recovered.

(b) Paragraphs 24 and following of IAS 12 should be amended to reflect the difference between the taxable profit that is defined in paragraph 5 of IAS 12 and the taxable profit that is used to assess the utilisation of deductible temporary differences.

(c) Paragraphs 24 and following of IAS 12 should be amended to explain that an entity can assume that it will recover an asset for more than its carrying amount when estimating probable future taxable profit against which deductible temporary differences are assessed for utilisation.

11. While the Interpretations Committee members did not object to the last two proposals, many of them considered the first proposal as unnecessary and even confusing.

12. Consequently, the draft amendment to IAS 12 in Staff Paper 2A only proposes to amend paragraphs 24 of IAS 12 as indicated in subparagraphs 10(b) and (c).

Unintended consequences

13. At its meeting in January 2014, the Interpretations Committee asked the staff to assess, when drafting the amendment, whether there are any unintended consequences for the accounting for deferred tax arising in relation to non-financial assets measured at fair value.

14. We identified the following non-financial assets that IFRSs allow or require to measure at fair value:

(a) items of property, plant and equipment that are subsequently measured using the revaluation model (see paragraphs 29 and 31 and following of IAS 16 *Property, Plant and Equipment*);

(b) intangible assets that are subsequently measured using the revaluation model (see paragraphs 72 and 75 and following of IAS 38 *Intangible Assets*);

(c) investment property that is subsequently measured using the fair value model (see paragraphs 30 and following of IAS 40 *Investment Property*); and

(d) biological assets are measured on initial recognition and at the end of each reporting period at their fair values less costs to sell (see paragraphs 12 and following of IAS 41 *Agriculture*).

15. For ease of reference, we refer to these assets as the non-financial assets measured at fair value.

16. We do not think that the amendments to IAS 12 will cause any unintended consequences for the accounting for deferred tax relating to the assets identified in the paragraph 14.

Existence of a deductible temporary difference

17. The amendment to IAS 12 would clarify that an unrealised loss on a debt instrument measured at fair values gives rise to a deductible temporary difference if the holder of the debt instrument expects to recover its carrying amount by holding it to maturity and by collecting all of the contractual cash flows, and if the loss is not tax-deductible until realised.

18. Such an unrealised loss gives rise to a deductible temporary difference even if the holder of the debt instruments expects that the deduction of the tax base will not reduce the taxable profit upon which income taxes are paid (see paragraph 5 of IAS 12), because this tax deduction will be counterbalanced by the cash inflow of the same amount from the repayment of the principal of the debt instrument.

19. This is because the cash inflow at maturity of the debt instrument is a taxable economic benefit to the entity in future periods, and the tax base of the debt instrument is a tax deduction.

20. We think the same principle is, and indeed should be, applied in accounting for deferred taxes related to the non-financial assets measured at fair value in practice (see paragraphs 20 and 26(d) of IAS 12).

21. Many debt instruments, however, share the following characteristics that distinguish them from the non-financial assets measured at fair value:

    (a) the repayment of the principle is in many cases tax neutral for the holder; and

    (b) the non-financial assets measured at fair value require additional transactions, eg sale transactions, to recover their carrying amounts. Debt instruments, in contrast, do not require such additional transactions. As long as the issuer is solvent, their carrying amount may be recovered simply by holding them until maturity.

22. In other words, the acquisition of a debt instrument that is held to maturity is the basis of both the tax base and the inflow of taxable economic benefits. The acquisition of the non-financial assets measured at fair value instead is only the basis of the tax base. The inflow of taxable economic benefits requires an additional basis, eg a sale transaction.

23. We think that these characteristics caused the need for the proposed clarification that an unrealised loss on a debt instruments measured at fair value gives rise to a deductible temporary difference if the holder of the debt instrument expects to recover its carrying amount by holding it to maturity, and by collecting all of the contractual cash flows and if the loss is not tax-deductible until realised. In the case of unrealised losses on non-financial assets measured at fair value in contrast, it seems to be clear that they give rise to deductible temporary differences.

24. Acknowledging the difference between both groups of assets, we do not think that these differences require different conclusions on whether unrealised losses give rise to deductible temporary differences.

Recovering an asset for more than its carrying amount

25. The amendments to IAS 12 would clarify that an entity assumes that it will recover an asset for more than its carrying amount when estimating probable future taxable profits against which existing deductible temporary differences are assessed for utilisation, provided such a recovery is probable.

26. We think the same principle is, and indeed should be, applied in accounting for deferred taxes related to the non-financial assets measured at fair value in practice.

27. We understand that entities assume in practice that they will recover many of their non-financial assets measured at fair value for more than their carrying amount, in particular if these assets are used in or related to profitable operations.

28. Finally, we think that the reason why such a clarification is needed for debt instruments measured at fair value, but not for non-financial assets measured at fair value, is again the fact that recovering non-financial assets measured at fair value usually requires additional transactions. In contrast, debt instruments measured at fair value do not require such additional transactions for recovering the investment in them. The debt instruments themselves are the basis of the inflows of the taxable economic benefits, if they are held until maturity.

Probable future taxable profit before deducting amounts resulting from the reversal of deductible temporary differences

29. The amendments to IAS 12 would clarify that probable future taxable profit against which existing deductible temporary differences are assessed for utilisation excludes tax deductions represented by those deductible temporary differences.

30. We think the same principle is, and indeed should be, applied in accounting for deferred taxes related to the non-financial assets measured at fair value.

31. This principle avoids double counting of tax effects.

Combined assessment

32. The amendments to IAS 12 would clarify that an entity assesses the utilisation of a deductible temporary differences in combination with other deductible temporary differences. If tax law, however, restricts the utilisation of deductible temporary differences so that an entity can only utilise certain tax deductions, against taxable profits of a specific type (for example, if it can deduct capital losses only against capital gains), the entity must still assess a deductible

temporary difference in combination with deductible temporary differences of the appropriate type.

33. We think the same principle is, and indeed should be, applied in accounting for deferred taxes related to the non-financial assets measured at fair value in practice.

34. This is because the clarification only highlights the requirements and limitations given by tax law for the utilisation of deductible temporary differences (see paragraph 27 of IAS 12).

Entity in a loss position

35. The amendment to IAS 12 would explain the approach to apply in the assessment of the utilisation of deductible temporary differences when it is probable that the entity will utilise only part of its deductible temporary differences. This was raised within the context of a situation in which all three sources of taxable profits (ie future reversal of existing taxable temporary differences, future taxable profit, and tax planning opportunities) are available but together are insufficient for the recognition of all deferred tax assets.

36. We do not think that these explanations would result in unintended consequences for non-financial assets measured at fair value. This is because they simply illustrate the application of the requirements for assessing the utilisation of deductible temporary differences in paragraphs 24 and following of IAS 12.

Split between profit or loss and OCI

37. The amendment to IAS 12 would explain how an entity should determine the amount of deferred tax to recognise in other comprehensive income, compared with the amount to recognise in profit or loss, when the entity cannot recognise all deferred tax assets because of having insufficient future taxable profits.

38. We do not think that these explanations would result in unintended consequences for non-financial assets measured at fair value. This is because they simply illustrate the application of paragraph 63 of IAS 12.

Staff recommendation

39. We drafted the amendment to IAS 12 on the basis of the requirements that the Interpretations Committee had laid down at its meeting in January 2014.

40. In this process, we did not notice any unintended consequences for non-financial assets measured at fair value.

41. Consequently, we recommend to the Interpretations Committee that it should recommend to the IASB that it should clarify the recognition of deferred tax assets for unrealised losses on debt instruments measured at fair value by the amendment to IAS 12 in Staff Paper 2A.

Questions for the Interpretations Committee

Question for the Interpretations Committee
1. What comments do the Interpretations Committee members have on the draft amendment to IAS 12 in Staff Paper 2A? 2. Do the Interpretations Committee members see any unintended consequences for the accounting for deferred tax related to non-financial assets measured at fair value from the proposed amendment to IAS 12? 3. Does the Interpretations Committee agree with the staff recommendation?